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IN THE

Supreme Court of the United States

OCTOBER TERM, 1934

No. 582

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

v.

JAMES L. RANKIN, Executor of the Estate of Richard B. Turner, *Respondent.*

On a Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENT.

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Counsel for Respondent.

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BRIEF FOR THE RESPONDENT.

OPINIONS BELOW

The findings of fact and the opinion of the Board of Tax Appeals (R. 8-11) are reported in 26 B.T.A. 1204. The opinion of the Circuit Court of Appeals (R. 25-27) is reported in 73 F. (2d) 9.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered September 18, 1934, (R. 28). The petition for a writ of certiorari was filed December 15, 1934, and was granted February 4, 1935 (R. 29). The jurisdiction of this court is invoked under Sec. 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented

1. Whether 1000 shares of stock held on margin and sold in 1928 were capable of identification and were in fact identified as the same lot purchased by the taxpayer earlier in the year.

2. Whether the so-called "first in, first out" presumption of the income tax regulations may be applied in the event the court holds shares of stock held on margin were not identified.

3. How should the gain on the sale of the shares be computed if the stock cannot be identified and if the "first in, first out" rule does not control?

Statutes and Regulations Involved

The applicable provisions of the Revenue Act of 1928 and of the Treasury Regulations applicable to property held for investment* are set forth in the brief for petitioner.

Statement of the Case

Since this case to some extent involves the question as to the sufficiency of the evidence to support the taxpayer's contention respecting the fact of identification, a more complete summarization of the facts is presented below than in petitioner's statement.

In 1926, the taxpayer, Richard B. Turner, now deceased, received in distribution of his father's estate $20,000 in

*As to whether applicable to stock purchased and sold in same year see petitioner's brief in *Snyder v. Commissioner*, No. 663.

bonds (R. 16). He did not believe in bonds and wanted to change this inheritance into stock (R. 16). At his direction his attorney opened for him a margin account with a Philadelphia broker and with the proceeds of the bonds purchased on margin 1200 shares of United Gas Improvement stock at about 98 (R. 15-17). He considered this purchase an investment (R. 20-21).

For nearly two years Turner had no further marginal transactions in this or any other stock (R. 15, 16-17). At the beginning of 1928 his margin account showed 1500 shares of U.G.I. stock long, the additional 300 shares representing a 25 per cent stock dividend on November 22, 1926 (R. 15). These 300 shares, received as a stock dividend, were sold on May 8, 1928 (R. 15), and there is no dispute between the parties as to the basis used in computing the profit thereon.

During 1928 Turner was kept away from his business by a serious illness and began to play the market as a pastime (R. 16-17, 21). Beginning on March 14, 1928, and continuing throughout the remainder of the year he bought and sold on margin in the same account a large number of stocks, the transactions usually being in 500 and 1000 share lots (R. 16-17).

Included in these speculative (R. 20-21) transactions of 1928 was a purchase of a lot of 1000 shares of U.G.I. stock on June 8, 1928, at about 143¼ (R. 15) which he sold (as claimed by respondent and as held by the court below) in two lots of 500 shares each on October 22 and November 7 at about 147½ (R. 15).

At the end of 1928 taxpayer's margin account was long 1200 shares of U.G.I., the same number he had held since 1926 (R. 17).

The uncontradicted evidence showed that Turner was extremely sentimental about keeping the original 1200 shares considered as an inheritance from his father (R. 16, 18-19); that he at all times intended to keep those particular shares and to sell in 1928 the 300 shares received

as stock dividend and the 1000 shares purchased in June of that year (R. 17-18); that he fully communicated that intention both to his business associates (who handled his affairs for him during his illness) and to the broker (R. 18-19); that his decisions to sell were reached on that basis (R. 20); that his books and records were kept and his tax return made on that basis (R. 21); that he at all times and repeatedly emphasized the distinction between the 1200 shares which he was holding as an investment and the 1000 shares which he bought and sold as a speculation (R. 18-21); and that he did everything in his power and control to effect that intention. Both lots of stock having been bought on margin he did not from the nature of things have custody or control of the certificates, but he saw to it that the broker was informed as to which shares he was keeping and which shares he was selling (R. 17-19). The Board of Tax Appeals found (R. 9) as a fact:

> "The decedent always intended to retain the ownership on margin of 1200 shares of the United Gas Improvement Co. stock since he had faith in the company and desired to hold that in lieu of the bonds which he had received from the estate of his father."

The Commissioner of Internal Revenue held that the shares sold in October and November, 1928, were not capable of identification by certificates as being from the lot purchased in June, 1928, and that the so-called "first in, first out" rule of Art. 58, Regulations 74, should be applied to determine the cost of the shares sold (R. 9). He thereby arbitrarily determined that the 1300 shares sold in 1928 consisted of 1040 shares out of the original 1200 shares plus 260 of the shares received as a stock dividend, and that the total basis for computing profit or loss should thus be reduced to $99,735 and the taxable profit correspondingly increased from $25,933.50 to $92,864 (R. 9). This arbitrary method of computing the profit in turn necessitated a complicated and equally arbitrary prorating of

the cost of the 1200 shares originally purchased as set forth at R. 9.

The Board of Tax Appeals sustained (R. 8-11) this arbitrary determination of the Commissioner and completely ignored the evidence that Turner's *intention* not to sell the 1200 shares purchased in 1926 had been *communicated* to the broker, and that everything had been done by the taxpayer which, in the nature of the case, could in fact be done by him to identify and specify the *lot* of shares from which the October and November sales were made.

The Circuit Court of Appeals reversed (R. 25-27) the Board, holding that full effect must be given to the communication of the taxpayer's intention to the broker respecting the specific lots to be sold and not to be sold, which amounted, under the principle established in several previously decided cases (which were discussed), to identification of the lot from whence came the shares sold. The court held (R. 27):

> "The Commissioner, the Board of Tax Appeals affirming him, ignored this action of the petitioner on the theory that the U.G.I. stock, which from time to time he purchased on margin, and later sold, could be identified only by certificates; * * *
>
> That was error. What was bought and sold were shares, not certificates. * * * Shares as distinguished from certificates are property subject to conversion and capable of identification. * * *
>
> The petitioner's instructions excluding from sale the shares first purchased were in effect an identification of the shares later sold as those last purchased.
>
> While the petitioner, in identifying his shares, might have been more specific in his instructions to his broker, those he gave stand uncontradicted; indeed, they have not been questioned. We think they were enough to take the case out of the rule and that, in consequence, the deficiency tax in issue is invalid to the extent that is it based on gains in sales of U.G.I. shares reckoned on the purchase price of the original 1200 shares."

Summary of Argument

I. *The Commissioner's disregard of the usual incidents of stock ownership and of the admitted intention of both the taxpayer and his broker concerning the lot of shares actually sold, and the unfair and unreasonable result of the deficiency determination, clearly demonstrate error in his method of computing the proposed tax and establish the correctness of the decision below.*

A purchaser of stock on margin is the owner of the stock, and has rights and liabilities as such. *Richardson* v. *Shaw*, 209 U. S. 365.

The effect of the Commissioner's determination is to deny the taxpayer holding stock on margin the right to make his own decision as to what shares he should sell and when, and therefore is to deny him fundamental incidents of ownership and rights accorded to taxpayers holding stock by identifiable stock certificates. Such result is not only arbitrary but discriminatory. *Howbert* v. *Penrose*, 38 F. (2d) 577. A further result of the Commissioner's determination is to deny any effect to the fundamental factor universally held determinative of the very legality of a marginal transaction, namely, the intent of the purchaser. These results are corrected by the decision of the court below.

The admission of the government that if the taxpayer's contentions are not sustained it "simply leaves him with an unenforcible claim" in itself illustrates the arbitrary and unfair character of the Commissioner's determination and argues strongly for the correctness of the decision below.

II. *The court below properly ruled that the 1000 shares held in the margin account and sold in 1928 could be and were identified as a lot purchased by taxpayer earlier in the same year; and that the cost of that specific lot is the basis for computing the taxable gain.*

Shares of stock held on margin are capable of identification by the specific lots purchased and sold, the lots be-

ing earmarked by the separate transactions recorded in the books and records of the purchaser and the broker, and it is immaterial that identification can not be made through means of stock certificates. *Richardson* v. *Shaw*, 209 U.S. 365; *Gorman* v. *Littlefield*, 229 U. S. 19; *Duel* v. *Hollins*, 241 U.S. 523; *Snyder* v. *Commissioner*, 73 F. (2d) 5.

The identity of a lot of stock sold out of a margin account can accurately be determined by reference to the intent of the seller as evidenced by his contemporaneous acts; such a rule is fair both to the taxpayer and the government, and is capable of practical application.

The decision below is in full harmony with established principles of the law of marginal transactions and the law of sales. It is also entirely consistent with and is supported by the decisions of the federal courts in tax cases involving identification of stock sold.

The facts in the present case are sufficient to distinguish it from *Snyder* v. *Helvering*, No. 663, now pending before this court.

III. *Even if the 1000 shares sold were not identified, the Commissioner's artificial and arbitrary "first in, first out" rule does not control this case.*

By its very terms Article 58, Regulations 74, providing for the "first in, first out" presumption, cannot be applied in cases like the present.

If shares of stock are incapable of identification, as a matter of law, the "first in, first out" principle can not be applied to *any sale* of corporate stock, because such rule may only be construed as reasonable and valid where applied to property which is in fact and in law capable of identification. In any event, if shares of stock held on margin are incapable of identification the "first in, first out" rule can not be applied in case of a sale of such stock, because it would create an irrebuttable presumption of fact and thereby be unconstitutional, as denying due process of law. *Heiner* v. *Donnan*, 258 U.S. 312; *Manley* v. *Georgia*, 279 U.S. 1.

IV. *If for any reason the "first in, first out" rule does not control, and if the shares sold are not identified, then the taxable profit must be ascertained under established principles of income tax law of general application.*

In such case no taxable gain will be realized until the taxpayer's capital investment in the stock shall have first been recovered in full. *Burnet* v. *Logan*, 283 U.S. 404.

In the alternative, the measure of the taxable gain is the difference between the price realized per share on the sale and the average cost per share of all such stock held at the time of the sale. While this rule has not received the sanction of this court it has recently been applied in cases analogous to the present. *Fuller* v. *Commissioner*, 31 B.T.A. 154; *Commissioner* v. *Stifel*, F. (2d), decided February 6, 1935 (C.C.A. 4th).

ARGUMENT

I. The Commissioner's disregard of the usual incidents of stock ownership and of the admitted intention of both the taxpayer and his broker concerning the lot of shares actually sold, and the unfair and unreasonable result of the deficiency determination, clearly demonstrate error in his method of computing the proposed tax and establish the correctness of the decision below.

Preliminary to a discussion of the technical questions of law involved in the identification of stock consideration must be given to the *practical* effect of the principles for which the parties respectively contend. This court has frequently announced that taxation is an *eminently practical* matter and that where possible tax laws require a practical construction. Cf. *Tyler* v. *United States*, 281 U.S. 497, 503. The court has sought if possible to construe tax laws to give effect to the *common understanding* as to what is and is not income. *Irwin* v. *Gavit*, 268 U.S. 161, 166.

As more fully shown below, the Commissioner proposes, in effect, by an administrative regulation having no specific sanction in the taxing act, to curtail the liberty of action of a citizen in respect of his dealings with his own property. He would disregard the intention of the owner, the usual legal incidents of ownership, and the ordinary understanding of business men as to the effect and character of a normal business transaction. On the other hand, the contentions advanced by respondent and sustained by the court below, give full and fair recognition to the practical exigencies of the case, to the rights of the owner of stock, to established law relating to marginal transactions, to the intent of the taxpayer as manifested by his conduct, and to trade practices long established. The principle for which respondent contends will not have the effect of curtailing tax revenues nor open any door to tax avoidance. The point here involved concerns solely the establishment of an administrative rule which is fair both to the taxpayer and the government and which is capable of execution in a consistent manner by the tax authorities.

At the outset it is to be observed that the Revenue Act itself says nothing about earmarking and identifying stock certificates, and in the absence of any such specific provision in the taxing statute the latter should be presumed to incorporate and follow the general law and the ordinary custom of business.

(a) *A purchaser of stock on margin is the owner of the stock, and has rights and liabilities as such.*

While at one time there may have been some question as to whether a purchaser of stock on margin was the owner of the stock, it is now well settled that he is the owner and the broker a mere pledgee of the stock as security for the purchaser's indebtedness to the broker for money advanced with which to acquire the shares. *Richardson* v. *Shaw*, 209 U.S. 365; *Gorman* v. *Littlefield*, 229 U.S. 19; *Duel* v. *Hollins*, 241 U. S. 523.

right, afforded to all other classes of taxpayers, to exercise his own free will in deciding which lot and what property he wishes to sell and when to sell.

It can hardly be questioned but that the construction and application of Article 58 which the Commissioner asserts in this case serve to deny a purchaser of stock on margin fundamental rights of ownership. As so construed and applied the Article is unreasonable and void.

In Meyer on "The Law of Stock Brokers and Stock Exchanges," Sec. 42, it is said:

> "*The customer is the owner of the securities* which are purchased by the broker on his behalf. This is true *even though the purchase is made on margin. It is the judgment of the customer which determines when the securities are to be purchased and when they are to be sold. All of the incidents of ownership are in the customer.* The risk of the purchase is his, and the broker, aside from his remuneration, has no interest therein. The profits *of the transaction* are the customer's, and the losses must be sustained by him. Dividends and stock rights belong solely to him."

The *right to sell* is one of the most elementary "incidents of ownership." Turner was the owner (*Richardson* v. *Shaw, supra*) of the particular 1000 shares which he purchased in 1928 and as such he had the right to sell them when and under such conditions as he saw fit. This right is expressly contemplated in the cases. The present transaction took place in Pennsylvania. In the leading Pennsylvania case on marginal transactions, *L. H. Taylor & Co's Assigned Estate,* 192 Pa. 304, the Supreme Court of Pennsylvania said—

> "stocks are as legitimate subjects of speculative buying and selling as flour or dry goods or pig iron. A man may buy any commodity, stock included, *to sell on an expected rise* * * *."

In the leading federal case on stock identification, *Howbert* v. *Penrole*, 38 F. (2d) 577, (C.C.A. 10th, 1930), the court quoted and approved the trial court's holding that:

> "Where a party has held stock for many years, and later buys more, and in this case it is admitted that plaintiff bought a great deal more after 1913 than he sold in 1918, *he has a right to decide which stock he is going to sell.*" The Government has not the power to say that if the taxpayer sells any of his holdings in a particular company, it can say conclusively that he sold the stock bought at the cheapest price or the shares purchased before or after a certain date. He has the right to decide that himself."

It is thus apparent that Turner had the absolute right to do exactly what he did, and the right being absolute it could not possibly have been either limited or completely abrogated by the mere fact that two years earlier he had bought some of the same stock as a permanent investment. He had the absolute right to buy these 1000 shares in the spring of 1928 at about 143¼ with the purpose of selling them when the prices advanced, and to so sell them as he did when the prices advanced to about 147½. He carried out all the steps necessary to effect that sale because he did everything that was either physically or legally possible for him to do in the premises. The mechanics of buying stock on margin have long been well known to the courts. The courts have recognized all along that in such cases certificates are never earmarked for particular purchases, but that the broker is entitled to commingle them and to hold them in various names, etc., frequently known as street certificates. This court in the *Richardson* case constantly referred to these conditions in the very opinion in which it held the purchaser was the owner and in which it supported its decision by reference to the various incidents of ownership which rested in him.

But if Turner was the owner of these particular 1000 shares, which he had purchased with the idea of selling on

a rise, and if as an owner he was entitled to sell them when they did rise, there must necessarily be something wrong with a regulation which in effect says that he could not so sell them. It conflicts with the established principles of law relating to the nature of marginal transactions and the status of the parties thereto. It reads into the law something that is not there and which under the decisions cannot be implied.

The decision of the court below construed and applied Article 58 in this case in such a reasonable and fair way that Turner's rights as owner of the stock were fully safeguarded. The fairness of the result the court reached is as highly persuasive of the correctness of its decision as the unfair and discriminatory character of the Commissioner's result is indicative of error in his determination.

(c) *A further result of the Commissioner's determination is to deny any effect to the fundamental factor universally held determinative of the very legality of a marginal transaction, namely, the intent of the purchaser; this is corrected by the decision of the court below.*

A speculative purchase of stock on margin is entirely legal. This form of transaction, however, is so easily capable of abuse, particularly through what have come to be known as "bucket-shops," that the courts early had to develop a definite test to determine the legality of marginal transactions. It is most significant that the one test which has thus been universally developed by the courts to distinguish between a perfectly legal although speculative purchase of stock on margin, as in the present case, and a mere bucket-shop transaction is the *intent* of the parties and particularly the intent of the purchaser. *Embrey* v. *Jemison*, 131 U. S. 336; *L. H. Taylor & Co.'s Assigned Estate*, 192 Pa. 304; *Wagner* v. *Hildebrand*, 187 Pa. 156; *Hurd* v. *Taylor*, 181 N. Y. 231.

If then intent is the major and practically the sole factor in determining the legality or illegality of such a tran-

saction, surely one who like Turner embarks on such an undertaking is entitled to have at least some weight given to that same intent in considering the purely subordinate and collateral question of what particular stock was bought or sold in the transaction the legality of which has just been established solely by the test of intent. Turner's speculative purchase on margin of 1000 shares in June of 1928 in the hope that he could sell the stock at an enhanced price was legal because he intended that the broker should actually make such a purchase, as he in fact did. Surely by the same token Turner may resort to that same intent to prove what stock he sold in completing the very transaction the legality of which has been established in the way just mentioned.

In the *Taylor* case the question arose on a customer's claim against an insolvent broker for long purchases on margin. The lower court disallowed the claim as a gambling transaction. The Supreme Court of Pennsylvania (the state in which all the transactions here in question took place) reversed this decision because the various stocks had been bought and sold as ordered by the customer and he testified that such had always been his intent. The court said at page 306:

> "It has been settled by this Court so often that it ought not to require reiteration that dealing in stocks even on margin is not gambling. Stocks are as legitimate subjects of speculative buying and selling as flour or dry goods or pig iron. A man may buy any commodity, stock included, to sell on an expected rise, or sell 'short' to acquire and deliver on an expected fall, and it will not be gambling. Margin is nothing but security, and a man may buy on credit, with security or without, or on borrowed money, and the money may be borrowed from his broker as well as from a third person. The test is did he *intend* to buy, or only to settle on differences?"

In the *Wagner* case a broker sued a customer. The same court announced the same rule in even more terse words at page 141:

> "A purchase of stock on margin for speculation is not necessarily a gambling transaction. If it is the *intention* of the parties that a real purchase shall be made by the broker, although the delivery may be postponed or made to depend upon future conditions, the transaction is legal; if it is the *intention* that there is not to be a delivery to complete the purchase, but that the account is to be settled on the basis of a rise or fall in prices, it is a mere wager, and the contract cannot be enforced by either party."

In the *Embrey* case this court held void a contract with a broker to purchase cotton futures on margin because neither party contemplated the purchase or delivery of actual cotton, but only the settlement of the difference through a payment by one party to another. The court said:

> "The mere form of the transaction is of little consequence. If it were, the statute against wagers could easily be evaded. The essential inquiry in every case is as to the necessary effect of the contract and the *real intention* of the parties. Mr. Benjamin in his Treatise on Sales (Vol. 2, 6th Am. Ed. by Corbin, p. 716, Sec. 828), after stating that at common law wagers that did not violate any rule of public decency or morality, or any reorganized principle of public policy, were not prohibited, says: 'It has already been shown that a contract for the sale of goods to be delivered at a future day is valid, even though the seller has not the goods, nor any other means of getting them than to go into the market and buy them.' 'But such a contract,' he proceeds to say, 'is only valid where the parties really *intend* and agree that the goods are to be delivered to the seller, and the price to be paid by the buyer.' "

Both the Commissioner in his determination and the Board in its opinion (R. 10-11) sustaining him ignored the taxpayer's intention, but the opinion below, reversing the Board and overruling the Commissioner, gives full and fair recognition to Turner's intent, and this opinion is

therefore consistent with the established law governing both ordinary sales and sales of stock on margin. The court said (R. 26-27):

> "'Evidence of intention of the owner of shares in transactions of purchase and sale though not dispositive of the question of identification has, nevertheless, a bearing on the ultimate question, what the owner did about it. Commissioner v. Merchants and Manufacturers Fire Insurance Company, 72 Fed. (2d) 408; Howbert v. Penrose, 38 Fed. (2d) 577. What Turner did in this case, acting and speaking through his attorney, was to communicate to his broker his intention to hold for investment the shares of U.G.I. he originally purchased."

(d) *The admission of the government that if the taxpayer's contentions are not sustained it "simply leaves him with an unenforceable claim" in itself illustrates the arbitrary and unfair character of the Commissioner's determination and argues strongly for the correctness of the decision below.*

That something is wrong with the Commissioner's determination in this case is practically admitted in petitioner's brief at pages 6-7 where it is said that:

> "Aside from the regulation, the burden was upon the taxpayer to show the cost of what was sold. This he did not and could not do. The impossibility of proving a material fact simply leaves him with an unenforceable claim."

The court below exercised sound judgment and avoided the possibility of any such result of leaving the taxpayer "with an unforceable claim" by permitting the identification of the lot of shares sold through reasonable means.

Further discussion of points illustrating the arbitrary and unreasonable character of any holding which would deny the right of identification and permit of the application of the "first in, first out" presumption in this case

is set out in Point III, subpoints (b) and (c), of this brief, where the invalidity of the regulation is asserted.

II. The court below properly ruled that the 1000 shares held in the margin account and sold in 1928 could be and were identified as a lot purchased by taxpayer earlier in the same year; and that the cost of that specific lot is the basis for computing the taxable gain.

In the light of the arbitrary, discriminatory and unreasonable result of the Commissioner's determination in this case, as shown above, there is a strong presumption that the holding of the court below was right, and, unless insurmountable legal technicalities prohibit a holding that the 1000 shares sold were identified, it should be affirmed. It offends one's sense of fairness to say that a man shall be taken to have sold property which admittedly he intended not to sell, and did everything legally possible to retain. "The mind staggers over giving sanction to a finding that something is true which we know is not true," *United States* v. *Alpha Portland Cement Co.*, 257 Fed. 432, 434.

(a) *Shares of stock held on margin are capable of identification by the specific lots purchased and sold, the lots being earmarked by the separate transactions recorded in the books and records of the purchaser and the broker, and it is immaterial that identification can not be made through means of stock certificates.*

The government renews its discredited contention that shares of stock are not capable of identification except by certificates. *The government has never been sustained by any court in such contention,* and cites no cases supporting such a view. The decisions are the other way. As pointed out in *Snyder* v. *Commissioner,* 73 F. (2d) 5, what are bought and sold in a margin account are *shares of stock,* not certificates which are mere evidence of title to the shares which constitute the property owned. The court there held:

"From the petitioner's statement of fact and his position on the law, it is obvious he has confused identification of shares and identification of certificates in transactions of sale. The rule deals with the sale and identification of 'shares of stock in a corporation,' not with sale and identification of certificates. Shares of stock and certificates for shares of stock are different legal entities. Shares of stock 'are intangible and rest in abstract legal contemplation.' They are the interest or right which the owner has in the management, profits and assets of a corporation. 14 C.J. Secs. 506, 509. Though incorporeal, they nevertheless are property and are the subject of conversion. 14 C.J. Sec. 509; 7 R.C.L. Sec. 166; *Skinner* v. *Eaton, Collector,* 45 Fed. (2d) 568. A certificate of stock, on the other hand, is the symbol or paper evidence of the ownership of shares; it is not the stock itself. It is merely written evidence, and then only *prima facie* evidence, of the ownership thereof by the person designated therein and of the rights and liabilities resulting from such ownership. 14 C.J. Secs. 698, 701, 702, 707, 709, 710, 1043. *Howbert* v. *Penrose,* 38 Fed. (2d) 577, 579. A stockholder may prove his ownership of shares by evidence other than that of the certificate, 14 C.J. Sec. 1272; and he may dispose of his shares and surrender his title therein by sale accompanied with delivery of a certificate in his name which he has endorsed with a blank assignment and power of attorney authorizing the transfer. 14 C.J. Secs. 1033, 1050; 7 R.C.L. Secs. 239, 243. As between seller and buyer the shares pass by mere delivery of the certificate, so endorsed, though the transfer as between the new owner and the corporation is not complete until made on the books of the corporation. When the new owner of the shares sells them without first having them transferred to himself on the books of the corporation and makes delivery by handing over the certificates so endorsed in blank by the original holder and starts it on its wanderings through the 'street,' the shares may go in one direction and the certificates in another; the shares, however, always being represented (in the rapid shifting of certificates between brokers) by a like certificate in the name of another, with endorsement in blank, held

> for the owner. Then 'ownership follows the owner, not the certificate.' *Howbert* v. *Penrose*, 38 Fed. (2d) 577, 579."

The Commissioner in his brief, at page 15, referring to the decision in the *Snyder* case, urges:

> "It recognizes that in marginal transactions certificates cannot be identified, but holds that shares, as distinguished from certificates, are capable of identification. This so-called distinction does not exist in a case of this kind."

This court long ago settled the point that there *is a distinction*, and a real one, between the stock certificates and the *shares of stock*. This court has repeatedly permitted customers of bankrupt brokers to identify their stock held on margin and to recover it *without identifying the stock by earmarked certificates*. Respondent submits that a similar method of identification, by reference to the recorded transactions, is equally permissable in tax cases. Consideration of the court's decisions in these bankruptcy cases will therefore throw much light on the present question, and somewhat lengthy quotations appear justified.

The nature of the relationship between a stockbroker and a customer for whom stocks were purchased on margin, and as well as the question as to where title to the stock lies, were discussed at length in *Richardson* v. *Shaw*, 209 U.S. 365 (1908). This court in that case held that a broker who turns over to a customer stock which he is carrying on margin for that customer, or certificates for an equal number of shares, does not make the customer a preferred creditor within the meaning of the bankruptcy law. The conclusion was reached that the customer was the owner of the stock from the time of its purchase and that—

> "although the broker may not be strictly a pledgee, as understood at common law, he is, essentially, a pledgee and not the owner of the stock."

In reaching such conclusion the court pointed out the essential nature of the shareholder's property right in the stock and the distinction between the shares and the certificates therefor, saying:

> "It is objected to this view of the relation of customer and broker that the broker was not obliged to return the very stocks pledged, but might substitute other certificates for those received by him, and that this is inconsistent with ownership on the part of the customer, and shows a proprietary interest of the broker in the shares; but this contention loses sight of the fact that *the certificate of shares of stock is not the property itself, it is but the evidence of property in the shares.* The certificate, as the term implies, but certifies the ownership of the property and rights in the corporation represented by the number of shares named.
>
> A certificate of the same number of shares, although printed upon different paper and bearing a different number, represents precisely the same kind and value of property as does another certificate for a like number of shares of stock in the same corporation. It is a misconception of the nature of the certificate to say that a return of a different certificate or the right to substitute one certificate for another is a material change in the property right held by the broker for the customer. Horton v. Morgan, 19 N.Y. 170; Taussig v. Hart, 58 N.Y. 425; Skiff v. Stoddard, 63 Connecticut, 198, 218. As was said by the Court of Appeals of New York in Caswell v. Putnam, 120 N.Y. 153, 157, 'one share of stock is not different in kind or value from every other share of the same issue and company. They are unlike distinct articles of personal property which differ in kind and value, such as a horse, wagon or harness. The *stock has no earmark which distinguishes one share from another*, so as to give it any additional value or importance; like grain of a uniform quality, one bushel is of the same kind and value as another.'"

The concurring opinion of Mr. Justice Holmes is also very significant. He said:

for gold coin, could properly be treated as indistinguishable tokens of identical values. That as between themselves, after paying amount due brokers, the customer had a right to demand delivery of stocks purchased for his account; and such delivery might have been made during insolvency without creating a preference."

From these cases it is clear that a person who purchases stock is the owner of the stock; that the shares of stock constitute property as to which the certificates are mere evidence of title; that the shares of stock so purchased and owned need not be identified by stock certificates; and that the customer's rights in the shares, as evidenced by the books of account, the contracts of the parties, and the intent of the parties, will be fully respected.

It must follow that Turner immediately upon execution by his broker of the order to purchase the 1000 shares of U.G.I. stock in 1928 became the owner of the 1000 share lot. His ownership and rights were evidenced by his books and records and by those of the broker. That was a single, identifiable transaction. And the same is true with respect to each of the several previous purchases of the same stock in 1926.

In the light of the cases above cited there can be no question that upon the sale of any lot of stock Turner was not required to identify the shares by particular certificates. These cases also hold that lots of stock held on margin can in law be sufficiently identified for all practical purposes by other evidence. Under the circumstances of a marginal transaction how may identity of a particular lot be shown? Obviously by any method or evidence which unequivocally records or points out the lot intended to be sold. The record in this case does not leave any doubt as to the particular lot Turner intended to sell. Both his records and the testimony of his associates established a definite and unequivocal selection of the 1000 share lot purchased in 1928.

(b) *The identity of a lot of stock sold out of a margin account can accurately be determined by reference to the intent of the seller as evidencd by his contemporaneous acts; such a rule is fair both to the taxpayer and the government and is capable of practical application.*

Conceding the possibility of identification of shares of stock and that this may be accomplished by means other than the certificates, the question at issue reduces itself merely to the sufficiency of evidence in a given case to convince a reasonable tribunal as to which lot of stock the owner intended to sell.

The whole purpose of the regulations is to ascertain: (1) the amount of the taxpayer's investment in a stock transaction, and (2) the amount realized when the transaction is closed by a sale of the stock. Since shares of stock are intangible, and cannot be identified as such, only a *transaction* of purchase, sale, exchange, or the like is subject, in the nature of the case, to identification. Any evidence therefore sufficient to identify a specific transaction in stock must be regarded as sufficient in law.

Significantly, Article 58 only applies where "the identity of the *lots* cannot be determined." Of course a lot of stock bought on margin is identifiable by the records of the broker and of the taxpayer. Each transaction is earmarked. There is no more difficulty in identifying a specific lot of shares bought on margin than the cost of the different lots. The same records show both the lot and the cost of the same. The man in the street would certainly not conceive of any such difficulty in identification as the Commissioner purports to find. Turner's right and title to the several lots of shares, here in question, was evidenced by the entries in his own and the books of account and records of the broker. In fact, were it not for his records the Commissioner could not have ascertained that he bought one lot in 1926 and another in 1928, nor the respective costs of the lots, nor the number of shares in each lot.

There is neither occasion or reason for the identification of the thing sold being required to go further than the identification of the thing bought. The latter has been identified by the Commissioner solely from Turner's intent, his books and records, and his tax return. The stock sold may very properly be identified in the same way.

Transactions in stock on margin have long been sanctioned by the law, and established trade practices have been developed. The course of such dealings and their legal effect are considered at length in *Richardson* v. *Shaw, supra*. The customer does not get a certificate covering his stock purchased on margin, nor does the broker earmark any certificate for him. While the outright owner of shares ordinarily (but not necessarily) has specific certificates to evidence his ownership, the owner of stock on margin has only the contract between himself and the broker to evidence his ownership. Normally that contract itself is merely evidenced by the memorandum records of the parties. But the long period of marginal dealings has not demonstrated any difficulty in identifying the customer's ownership in usual course of business. The Commissioner appears to ignore this established business practice and refuses, for tax purposes, to recognize the very indicia of stock ownership which the parties themselves accept every day as competent and satisfactory evidence of the ownership which the courts hold the marginal trader has as a matter of law.

As already seen, in case of sale of stock on margin as well as in the case ordinary sales, it is the *intent of the seller* which is the controlling factor. Legality of the transaction, when title passes, etc., are all ascertained by reference to the owner's intent. Even where the customer has identifiable stock certificates and they are sold by his broker, in the absence of intent to make a sale, no sale of the stock results. *In re Woody*, 57 F. (2d) 207 (1932). Clearly intent must be the controlling factor in identification of what is sold.

If the seller offers *no evidence* whatever from which his intent may be determined with fair certainty then it may well be that some such presumption as the "first in, first out" rule should, with fairness and good reason, be resorted to in the administration of the tax law. Respondent would not contend otherwise. But where the taxpayer's intent is established by uncontroverted evidence (as in this case, where Turner's intent to sell the stock acquired in 1928 is admitted by the Commissioner to be firmly established) and no reasonable person could doubt what the seller purported to sell, the arbitrary presumption has no place.

There is no good reason, from the standpoint of good administration of the tax laws, which requires resort to an artificial rule to ascertain the stock sold. The property rights of the seller are protected and justice accomplished without violence to any principle of law or rule of convenience by permitting identification by satisfactory proof of intent. This is all that the decision of the court below requires.

A rule which will permit of identification by proof of intent is wholly practical of administration. Intent is susceptible of proof. Proof of intent is required every day in other fields of law. The Commissioner of Internal Revenue must frequently be satisfied as to a taxpayer's intent in connection with other matters. If it can be established for other legal purposes, it can be established in a case where a taxpayer holds stock in the margin account.

Apparently the Commissioner desires to establish a rule of thumb which will permit his auditors to compute the gain or loss on the sale of stock held on margin without reference to the true facts. But when such an easy way out does violence to the very fundamental incidents of ownership in property and results in the realization of a taxable gain (or loss) never intended by the taxpayer, obviously the protection of the rights of the citizen far out-

weigh any consideration of convenience in auditing tax returns.

Where a taxpayer, as in this case, by clear and convincing evidence establishes the *lots* of marginal stock to be sold, that is sufficient identification; where there is no such clear earmarking of the *lot* sold there is no identification. That seems to be the principle of law involved in this case. It is hard to see how any such holding can possibly, as petitioner suggests, "create considerable confusion and doubt as to the proper rules to be applied in these cases."

Obviously no principle can be formulated which will relieve the taxing officials and the Board from considering evidence in particular cases as they arise, or from their duty to make findings of fact as to whether the taxpayer did or did not by properly *manifested* intent and consistent performance designate the lot of shares in his margin account to be sold.

(c) *The decision below is in full harmony with established principles of the law of marginal transactions and the law of sales.*

The opinion of the court below in this case was handed down the same day as its opinion in the *Snyder* case, and the latter opinion was cited and relied on as establishing the law in respect of identification. There the court ruled that stock held on margin was capable of identification, citing many authorities. The relevant portion of that opinion is quoted *ante* page. It is to be observed that the conclusion of the court respecting the possibility of identification of stock, by means other than certificates, is entirely consistent with and sustained by this court's opinions in *Richardson* v. *Shaw*, *Gorman* v. *Littlefield* and *Duel* v. *Hollins*, heretofore quoted and discussed.

The consistency of the decision of the court below in this tax case with decisions in other fields involving stock held on margin speaks much for the soundness and correctness of the judgment.

(d) *The holding below is entirely consistent with and is supported by the decision of the federal courts in tax cases involving identification of stock sold.*

In addition to its consistency with opinions of this court and with other authorities in the general field of the law, the decision below is fully supported by and is wholly consistent with other court decisions in the narrower field of stock identification for tax purposes. The court cites and relies on these other cases. Aside from *Cole* v. *Helburn*, 4 F. Supp. 230, petitioner cites no other court cases. Petitioner cites several Board of Tax Appeals cases, but admittedly certain of the opinions of the Board can neither be reconciled with each other nor with the court decisions.

The court below held in substance that shares of stock are capable of identification; that the law does not require identification by earmarking certificates; that the intent of the seller must be considered in making identification; that a mere mental intent, not crystalized into action, is insufficient from the standpoint of satisfactory evidence; and that intent of the seller as shown by his statements and performance is sufficient. Such holdings are severally consistent with the decided cases dealing with identification of stock and the application of the "first in, first out" rule. *Howbert* v. *Penrose*, 38 F. (2d) 577; *Skinner* v. *Eaton*, 45 F. (2d) 568; *Snyder* v. *Commissioner*, 54 F. (2d) 57; *Horner* v. *Commissioner*, 72 F. (2d) 407; *Commissioner* v. *Merchant's & Mfgrs. Fire Insurance Co.*, 72 F. (2d) 408; *Snyder* v. *Commissioner*, 73 F. (2d) 5; *Cole* v. *Helburn*, 4 F. Supp. 230. See also *Towne* v. *McElligott*, 274 Fed. 960. The validity of the rule, when construed merely as a presumption as to the shares sold *where no evidence is offered as to identity of lots and dates of purchase*, was not questioned in those cases. It is not questioned in this case, if construed to permit a taxpayer to identify his shares after the manner employed by Turner here.

The cases cited all agree on those fundamental principles concerning the law of identification. With respect to the decision in a particular case on the point of the sufficiency of the evidence to satisfy the demands of reasonable certainty, an astute lawyer might argue that a different conclusion should have been reached in some of the cases.

This brief would be unduly lengthened by a detailed consideration of the cases cited. They all tend to sustain respondent's contentions; certainly none requires a contrary holding. In the petition for the writ (p. 5) it was suggested that the decision below was in conflict with *Skinner* v. *Eaton*, but that case did not even involve stock purchased on margin. In that case there was some evidence of the taxpayer's intent, *expressed several years previous to the sale*, to retain his first purchases but no proof that any effort was made to carry this intention into effect or to keep a record of ths stocks acquired and sold. Here Turner communicated his intent to the broker and *did everything that it was possible to do to identify the lot of shares to be sold* and especially to preclude the sale of the lot purchased in 1926. The *Skinner* case did not hold, nor even suggest as *dicta* that shares of stock purchased on margin *could not* be identified, or that shares could *only* be identified by certificate numbers.

Howbert v. *Penrose, supra*, is not only consistent with the decision below, but seems to go further and to hold that the declared intention of the taxpayer as to what stock is to be sold is sufficient in itself. The two *Snyder* cases did, however, involve marginal transactions. They were decided by the same court which decided this case, and the second *Snyder* case was decided the very same day as the present. The court distinguished those cases on their facts and it cannot reasonably be contended the two decisions thus simultaneously rendered are in conflict. Neither the *Horner* nor the *Merchants* cases involved marginal transactions and there can be no conflict. They

are cases where the stock actually identified as sold was not that intended to be sold. *Cole* v. *Helburn*, 4 F. Supp. 230, did not involve a marginal sale, and was simply a case where no instructions were given the broker as to what stock to sell.

It is significant that the Board of Tax Appeals has cited the decision below with approval and as being consistent with the previously decided cases by the courts and the Board. See *George Vawter* v. *Commissioner*, 31 B.T.A. 884.

(e) *The facts in the present case are sufficient to distinguish it from Snyder v. Helvering, No. 663, now pending before this court.*

The court below, consistently with prior decisions, ruled identification to be "a matter of fact" (R. 45), and upon a careful consideration of the evidence held it to establish that Turner as a matter of fact had identified the stock sold in October and November, 1928, as being the lot purchased in June, 1928. The case thus turned on the weight and sufficiency of the evidence to support the Board's conclusions, and the Board was reversed because of its failure to give effect to the communication of Turner's intention to his broker respecting the specific lots of stock to be sold and not to be sold, and to the corroborating evidence as to identification.

The court did not, as suggested at page 7 of the petition for the writ, allow "a mere declaration of intention to take the place of the factual identification required by the regulation"; it was careful to point out that under the decided cases, "his 'intention' • • • clearly was not enough to take the case out of the rule" (R. 46), and that there was "something else" in this case (R. 45). This "something else" was stated (R. 46) to be:

> "What Turner did in this case, acting and speaking through his attorney, was to communicate to his broker his intention to hold for investment the shares of U.G.I. he originally purchased. His decisions to

> sell like shares later purchased were reached on that basis; his books and records were kept on that basis; and, accordingly, his income tax return was made on that basis.".

Hence the present case differs from the *Snyder* case principally on the point of sufficiency of the evidence. There is no difference in the fundamental question of law involved.

In the present case there is concrete evidence that taxpayer's mental intent to retain the 1926 lot was crystalized into definite, recorded action from which no inference can be drawn other than that such stock should not be sold. *Turner's performance, as well as his intent, was only consistent with a hypothesis of identification of the 1928 lot.* Apparently in the *Snyder* case the court did not consider the taxpayer's intention to be sufficiently manifested by overt acts as to permit full effect to be given to the intention. Snyder may have had the intent to sell certain classes of stock but he did nothing of a definite recorded character to carry such intention into effect. Turner did everything that he reasonably could do to designate, at or before the sale, which stock should be retained and which sold. The broker had his instructions.

The distinction between the present case and cases where mere intent is proved (as in the *Snyder* case) is recognized and concisely stated by the Board in *Vawter* v. *Commissioner*, 31 B.T.A. 884, 886, as follows:

> "Intention alone, it has frequently been held, is not a criterion, *Skinner v. Eaton, supra; Courtenay D. Allington, supra;* nor is the taxpayer's mere mental or verbal labeling of the shares sold. *The claimed identification must at least be consistent with his actual performance, Horner* v. *Commissioner, supra; Commissioner* v. *Merchants' & Manufacturers' Fire Insurance Co., supra; Rankin* v. *Commissioner*, 73 Fed. (2d) 9."

Respondent here will leave to Snyder's counsel argument as to whether the evidence in his case was, under the

principles discussed in this brief, sufficient to require the same judgment there as in the present case. But respondent does contend that there is no inconsistency between the lower court's simultaneous decisions in the two cases, and that this court could, on the difference in the evidence, affirm both judgments.

III. Even if the 1000 shares sold were not identified, the Commissioner's artificial and arbitrary "first in, first out" rule does not control this case.

On this branch* of the case there are two considerations —does Article 58, by its terms, apply; and, if so, is it valid as applied to marginal stock transactions? The Commissioner's brief does not touch on the first question, which is discussed below. The second of these questions also has a twofold aspect—is the regulation valid as applied to ordinary stock transactions; and, if so, is it also valid as applied to stock transactions in a marginal account?

(a) *By its very terms Article 58, Regulations 74, providing for the "first in, first out" presumption, can not be applied in cases like the present.*

This article, so far as here material, provides:

> "When shares of stock in a corporation are sold from lots purchased at different dates and at different prices and the identity of the lots cannot be determined, the stock sold shall be charged against the earliest purchases of such stock."

By its very terms it is applicable only when stock is sold "from *lots* purchased at different dates and at different prices." That is distinctly not the case here. The evidence shows that the 1000 shares of stock were sold from the one single lot of 1000 purchased at one date and at one price (R. 9).

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*Counsel must beg the court's indulgence for the length of this brief, but the necessity for presenting an alternative argument leaves no other course open. If the court agrees that Turner identified the stock, no consideration is required of this and the remaining points.

'no earmark which distinguishes one share from another'," and on the very next page urges that "The usual method of identification is, of course, by tracing the shares through certificates."

It is therefore difficult to gauge the Commissioner's real contention in this case. He must take one or the other of the two positions—either that shares of stock are legally capable of identification, or that they are not. If the first position is assumed, it would seem to follow, for reasons fully set forth in Point II of this brief, that there was a sufficient identification here of the 1000 shares sold in 1928; if the second position is assumed, it must follow that Article 58 can not be applied because it was only intended to be effective and can only reasonably control in cases where identifiable property is involved.

The design of the regulation is to identify the shares sold out of certain "lots" which are assumed to be capable of identification. If the property is of such an intangible and unitary character that no separate part can be distinguished, obviously a "first in, first out" presumption can not be applied, because it will prove equally as impossible to identify the shares "first in" as those "first out."

It is respondent's contention, of course, that shares of stock are capable of identification by lots, as heretofore shown. However, it must be admitted that the question is not entirely free from doubt. It has not been touched upon by this court in any income tax decision. For tax purposes it has heretofore been considered that shares are subject to identification and in many cases this has proven a workable principle. Where, however, stock has been held a long time, where there have been stock dividends, changes in par value, exchange of certificates, loans of stock paid back with other similar stock, etc., the rule has given rise to great practical difficulties. In the recent case of *Alvan T. Fuller* v. *Commissioner*, 31 B.T.A. 154, the

Commissioner attempted to apply the "first in, first out" presumption, and the Board found:

> "The basis * * * used by the Commissioner in determining the profit on the sale of the 25,000 shares was derived from an elaborate and complicated computation made by a revenue agent, *which consumed 11 full pages* of the agent's report."

In G.C.M. 11742 (Int. Rev. Bull. XII-2, p. 31) there is an excellent example of the complications encountered in the administration of the presumption. It was there admitted that:

> "While this may appear at first glance to be carrying the presumption of 'first in, first out' to rather ridiculous extremes, it must be recognized that, at best, the presumption is simply an arbitrary 'rule of thumb' which the courts have upheld."

That illustrates the logical and usual consequence of holding that shares may be identified, and of attempting to apply its correlative principle that upon failure to identify in fact, the presumption should apply.

Only recently the Board of Tax Appeals in *Vawter* v. *Commissioner*, 31 B.T.A. 886, pointed out the difficulty of reconciling the principle of *Richardson* v. *Shaw* with the theory of Article 58, saying:

> "The rule is one of administrative convenience and necessity, the purposes of which are uniformity of taxation, certainty of determination, and simplicity of computation. Broadly speaking shares of the same class are fungible, each representing a proportionate interest in the whole and each new acquisition being absorbed into the expanding interest of the shareholder. *Richardson* v. *Shaw*, 209 U.S. 365; *Duel* v. *Hollins*, 241 U.S. 523; *Howbert* v. *Penrose*, *supra*; *Snyder* v. *Commissioner*, *supra*; *Burdett Stryker*, 21 B.T.A. 561. In this sense shares defy identification. *To what extent the administrative practice departs from this concept or upon what theory the concept is modified so as to recognize an identification is difficult to learn from the cases which have been litigated.*"

The point which respondent makes here is that should this court hold shares of stock incapable of identification, as a matter of law, then the "first in, first out" presumption can not be applied and resort must be had to other principles of tax law, considered in Point IV, to measure the gain or loss.

(c) *If shares of stock held on margin are incapable of identification the "first in, first out" rule cannot be applied in case of a sale of such stock, because it would create an irrebuttable presumption of fact and thereby be unconstitutional, as denying due process of law.*

Whatever may be the Commissioner's position as to whether shares of stock generally are capable of identification, it is clear from his brief that he takes the definite position that (p. 10) "particular shares held on margin are not identifiable." Even if the court agrees with this contention it does not follow that the "first in, first out" rule may be applied here. The validity of the regulation in the light of its application to such a case as this must also be considered.

It is submitted that, as applied to shares of stock held on margin and regarded as not subject to identification, the regulation creates an irrebuttable presumption of fact, which this court will not sanction. The point is controlled by *Heiner* v. *Donnan*, 258 U.S. 312.

In the *Donnan* case the court held void a provision in a federal estate tax law establishing a conclusive presumption that every gift made by a decedent within two years of death was in contemplation of death. The provision was held unconstitutional as in violation of the Fifth Amendment. The court said:

> "a statute which imposes a tax upon an assumption of fact which the taxpayer is forbidden to controvert, is so arbitrary and unreasonable that it cannot stand.
>
> * * * * * * * * *
>
> This court has held more than once that a statute *creating a presumption which operates to deny a fair*

opportunity to rebut it violates the due process clause of the Fourteenth Amendment. For example, *Bailey* v. *Alabama*, 219 U.S. 238; *et seq.*; *Manley* v. *Georgia*, 279 U.S. 1, 5-6. 'It is apparent,' this court said in the *Bailey* case (p. 239) 'that a constitutional prohibition *cannot be transgressed indirectly* by the creation of a statutory presumption any more than it can be violated by direct enactment. The power to create presumptions is not a means of escape from constitutional restrictions.' "

In *Manley* v. *Georgia*, 279 U.S. 1, 6, the court held:

"A *prima facie* presumption casts upon the person against whom it is applied the duty of going forward with his evidence on the particular point to which the presumption relates. A statute creating a presumption that is arbitrary or *that operates to deny a fair opportunity to rebut it* violates the due process clause of the Fourteenth Amendment. *Bailey* v. *Alabama*, 219 U.S. 219, 233 *et seq. Mere legislative fiat may not take the place of fact in the determination of issues involving life, liberty or property.*"

From the Commissioner's concession that shares of stock held on margin are not capable of identification, and that in every such case it must be taken, *as a fact*, that the first shares purchased were those first sold, it follows that the effect of Article 58, if applied to such shares, is to create a presumption which operates to deny a fair opportunity to rebut it.

The Commissioner urges at page 21 of his brief that "Since the attack is on the ground that the due process clause is violated, the question is simply whether the regulation is reasonable." Even assuming, for sake of argument, this is the controlling issue, the answer does not aid petitioner's case. The unreasonable and discriminatory effect of the regulation in this case is fully discussed in Point I. There may be cases where the regulation may be enforced fairly and reasonably, but it is all too clear that the application of the article here produces an absurd and

wholly unreasonable result. The Commissioner by its application found that Turner in 1928 sold a part of the 1200 shares purchased in 1926 (R. 9). Clearly he owned these 1200 shares (*Richardson* v. *Shaw*) and equally clearly he intended to keep them. One of the incidents of that *ownership* for purposes of the income tax acts is the right "to decide" to keep certain shares and to sell certain shares. *Howbert* v. *Penrose,* 28 F. (2d) 577, 578. He did decide to do a certain thing, he had a right to do that thing, and he did everything within his power to do it, and if any regulation arbitrarily and unnecessarily says he must be presumed to have done just the opposite thing, that regulation is obviously unreasonable. That the provisions of the Article are arbitrary has been expressly ruled. *Snyder* v. *Commissioner,* 54 F. (2d) 57-58. That it is necessary only "in the absence of something else" is ruled in the same paragraph of the opinion in that case. It cannot therefore be necessary where as here there is no "absence of something else." On the contrary, as shown in Point II, *supra,* there is here very much more "something else" than there was in the *Snyder* case.

Furthermore, this court will take judicial notice of the extensive volume of trading in stocks on margin. This is an established method of business dealing. To be reasonable any tax regulation must be designed to take into account the normal established course of marginal transactions. It should provide a rule which will not unduly discriminate between those taxpayers who purchase stocks outright and those who purchase on margin. Both contribute substantially to the federal revenues. A reasonable rule must either permit of identification in a fashion such as employed in this case or must dispense entirely with the necessity for identification of shares. No rule can be reasonable which will wholly deny the right to identify, and thereby place the marginal trader at distinct tax disadvantage as compared with others dealing in shares of stock. In law both have the same rights of ownership in

stock (*Richardson* v. *Shaw, supra*) and both should sustain the same tax liability upon a sale of like property.

Construed to apply to shares of stock regarded as legally incapable of identification, it is submitted that Article 58 is arbitrary and unreasonable, and, under the decided cases, therefore unconstitutional and void. *Robinson v. Lundrigan*, 227 U. S. 173. It can have no effect in the present case.

IV. If for any reason the "first in, first out" rule does not control, and if the shares sold are not identified, then the taxable profit must be ascertained under established principles of income tax law of general application.

In the preceding point three distinct reasons why Article 58 does not control in this case are discussed. If for any reason (and there may be others equally as cogent as those advanced herein by respondent) the "first in, first out" presumption can not here be applied, and the court further holds Turner did not identify the shares sold, then the question arises as to how to determine the base for ascertaining gain or loss on the sale of the shares. One of two principles of tax law would seem to apply. Both are discussed below.

(a) *In such case no taxable gain will be realized until the taxpayer's capital investment in the stock shall have first been recovered in full.*

In the absence of identification and of any controlling tax regulation the general principle of law applicable is that announced by this court in *Burnet* v. *Logan*, 283 U.S. 404. That, too, was a case of sale of shares of stock. The facts were somewhat different, but a general principle was announced which is equally applicable in all cases where for one reason or another it is impractical to compute exactly how much of each receipt is profit. In that fundamental respect that case and the present one are substantially alike and the general rule applied in one must from

its very nature be equally applicable in the other. There a block of stock had been sold for a lump sum plus a future annual payment of an indeterminate amount. The question was what part, if any, of the first payment was profit, which is identically the same question as in the present case. There, as here, the Commissioner had proposed an arbitrary method (in that case a prorating of each dollar received as part return of cost and part profit), but he had no duly promulgated regulations to support him. This court said at page 412:

> "The circuit court of appeals held that, in the circumstances it was impossible to determine with fair certainty the market value of the agreement by the Youngstown Company to pay 60 cents per ton. *Also, that respondent was entitled to the return of her capital*—the value of 250 shares on March 1, 1913, and the assessed value of the interest derived from her mother—*before she could be charged with any taxable Income. As this had not in fact been returned, there was no taxable income.*
>
> *We agree with the result reached by the circuit court of appeals.*
>
> The 1916 transaction was a sale of stock—not an exchange of property. We are not dealing with royalties or deductions from gross income because of depletion of mining property. Nor does the situation demand that an effort be made to place according to the best available date some approximate value upon the contract for future payments. This probably was necessary in order to assess the mother's estate. *As annual payments* on account of extracted ore *come in they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond.* The consideration for the sale was $2,200,000.00, in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper

> sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921 all receipts from the sale of her shares amounted to less than their value on March 1, 1913. *She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.*"

By a curious coincidence, which is not altogether without significance, a later sentence of Article 58 provides, with regard to the sale of stock acquired under somewhat different circumstances, as follows:

> "Where common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such common stock and the securities purchased for the purpose of determining the portion of the cost attributable to each class of stock or securities, but if that should be impracticable in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sale shall have been recovered the total cost."

That two additional and entirely different principles should be thus in effect legislated into this very same article of the regulations does not speak any too strongly for the reasonableness and the fairness of the third principle for which petitioner contends in this case. Passing that by, however, the important thing is that the same article of the regulations recognizes prorating, and if that is inapplicable, then a complete withdrawal of investment untaxed before any profit is realized as being at least equally reasonable. This last principle that no profit is realized on any sale of part of the stock until out of the proceeds of the sales the total cost has been recovered is the one recognized in the *Logan* case as generally applicable in the absence of any valid regulation.

Respondent contends that the 1000 shares sold in the fall of 1928 have been identified and that there was a substanial profit and a corresponding tax thereon as originally returned by Turner. But if this court should hold otherwise respondent submits that in no event is the presumption of Article 58 applicable, and that in that event the profit, if any, must be determined in accordance with the principle approved and applied in the *Logan* case.

(b) *In the alternative the measure of the taxable gain is the difference between the price realized per share on the sale and the average cost per share of all such stock held at the time of the sale.*

It will be observed that this alternative suggestion that the cost be apportioned to the shares held is recognized by the provision of Article 58, quoted above, as proper where stock is received as a bonus and some method of allocating the purchase price is necessary.

This principle has recently been applied by the Board of Tax Appeals to stock received in a non-taxable reorganization in exchange for stock previously held, the cost of the old stock being required to be apportioned ratable to the new shares. *Fuller* v. *Commissioner*, 31 B.T.A. 154; *Oliver* v. *Commissioner*, 30 B.T.A. 1380; *Von Gunten* v. *Commissioner*, 28 B.T.A. 702. In *Commissioner* v. *Stifel*, decided February 6, 1935, the Circuit Court of Appeals for the Fourth Circuit affirmed the Board in applying such averaging principle under the same circumstances. Cf. *Ayer v. Blair*, 25 F. (2d) 534.

The principle of allocating the cost to the number of unidentified shares held is also supported by decisions in cases involving the estates of bankrupt stock brokers. It is held that where the estate is found to have a lesser number of unearmarked shares of a particular stock on hand than the broker is obligated to deliver, his customers, although unable to identify their respective shares, are en-

titled to receive *pro rata* parts of the shares on hand. *Duel* v. *Hollins*, 241 U. S. 523.

Furthermore, it may be argued with some force that a shareholder has but a single divisible interest in a corporation, which may be evidenced for convenience by any number of distinct stock certificates. On such a view a sale of a part of his stock is but a disposition of a proportionate part of his undivided interest. It would follow, for tax purposes, that the basis for determining gain or loss upon a sale of stock would in any event be that proportion of the total cost of the shareholder's interest which the number of shares sold bears to the total number owned at the time of the sale.

The apportionment principle has the advantage of simplicity of application, and perhaps conforms more nearly to the method customarily used by the average business man. Respondent submits that either this rule or that of first recovery of capital investment (*Burnet* v. *Logan*, *supra*) afford reasonable means of determining the cost basis to be used in computing gain or loss upon the sale of any stock which is legally incapable of identification.

Conclusion

It is submitted that the decision below is correct and is in harmony with the decided case. The judgment should be affirmed.

Respectfully submitted,

John W. Townsend,
Counsel for Respondent.

March, 1935.

CORRECTED COPY

P. 7

SUPREME COURT OF THE UNITED STATES.

No. 582.—October Term, 1934.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* James L. Rankin, Executor. } On Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[April 29, 1935.]

Mr. Justice Brandeis delivered the opinion of the Court.

The Revenue Act of 1928 (c. 852, §§ 22, 111, 112, 113) provides, as had earlier Revenue Acts, that in computing income from sales of property purchased after February 28, 1913, any excess of the amount realized over cost shall be gain and that any excess of the cost over the amount realized shall be loss. When gain or loss is to be determined on the sale of stock owned outright as an investment, the identification of the shares sold with those purchased ordinarily presents no difficulty. But when the taxpayer has engaged in marginal transactions on a stock exchange, the identification of sales and purchases is frequently impossible. It was, perhaps, primarily to deal with such cases that the Treasury adopted, in 1918,[1] the so-called "First-in, first-out" rule. That rule appears in Article 58 of Regulations No. 74, under Revenue Act of 1928, as follows:

"When shares of stock in a corporation are sold from lots purchased at different dates and at different prices and the identity of the lots can not be determined, the stock sold shall be charged against the earliest purchases of such stock. The excess of the amount realized on the sale over cost or other basis of the stock will constitute gain."

Applying this rule, the Commissioner of Internal Revenue assessed against Richard B. Turner for the year 1928, a deficiency tax of $11,173.05 on account of gains from his operations on the stock exchange in United Gas Improvement Co. stock. Upon a redetermination by the Board of Tax Appeals, the Commissioner's action was sustained. 26 B. T. A. 1204. The Court of Appeals reversed the Board's decision and directed it to enter a new order

[1] Art. 4, ¶ 60, Regulations No. 33 (Revised), Revenue Acts of 1916 and 1917; Art. 39, Regulations Nos. 45, 62, 65 and 69, Acts of 1918, 1921, 1924 and 1926, respectively; Art. 58, Regulations Nos. 74 and 77, Acts of 1928 and 1932 respectively; Art. 22 (a)-8, Regulations No. 86, Act of 1934.

in conformity with the court's opinion. 73 F. (2d) 9. Turner having died during the litigation, his executor, Rankin, was substituted. Writs of certiorari were granted in this case, and in *Snyder* v. *Commissioner of Internal Revenue*, No. 663, decided this day, in order to determine questions concerning the effect, validity, and applicability of the regulation. 293 U. S. —. The facts found by the Board were these:

In 1926, Turner received in distribution of his father's estate $20,000 in bonds. Wishing to change his inheritance into stock, he opened a marginal account with a stock broker; sold the bonds; and, with the proceeds as margin, purchased, from time to time during that year, an aggregate of 1,200 shares of United Gas Improvement Company stock at a cost of $117,202.50. On this stock the broker received for him, later in 1926, 300 shares as a dividend. There were no further operations in 1926 or in 1927. His marginal account became active in 1928. At the beginning of the year he was long 1,500 shares of this stock; in May he sold 300 shares for $44,619 net; in June, he bought 1,000 shares for $143,225; in October he sold 500 shares for $73,865; and, in November, 500 shares for $74,115. Thus, at the close of the year, he was long 1,200 shares.

In none of these transactions did the broker deliver to Turner, or Turner to the broker, any stock certificate. No specific certificate of stock was ever bought or sold by the broker for Turner; and none was earmarked or allocated for him in any manner. The purchases and sales affecting his account were made through the medium of street certificates handled by the broker; and the transactions were evidenced solely by debits and credits in his account on the broker's books. Turner first learned these facts after the deficiency assessment. He had always intended to retain ownership on margin of 1,200 shares of the stock, since he had faith in the company and desired to hold them in lieu of the bonds which he had received from the estate of his father. To his business associates, who acted for him in giving orders to the broker, he had made it plain that the 1,200 shares were in the nature of a permanent commitment on his part. An employee of the broker understood that the decedent desired to retain 1,200 shares of the stock to take the place of the bonds which he had received from his father.

On the above facts the Board concluded, as had the Commissioner, that it was impossible to determine the identity of the lots

purchased and sold; and that, consequently, the "First-in, first-out" regulation should be applied. In reversing that order the Court of Appeals said:

"We think the petitioner's [Turner's] communication to his broker of his intention to hold the 1,200 shares first purchased as an investment was in effect an order to his broker not to sell those shares, and when, two years later, he ordered the broker to make two sales in lots of 500 shares each, they were, conformably with the original instructions, the 1,000 shares last purchased. The petitioner's instructions excluding from sale the shares first purchased were in effect an identification of the shares later sold as those last purchased.

While the petitioner, in identifying his shares, might have been more specific in his instructions to his broker, those he gave stand uncontradicted; indeed they have not been questioned. We think they were enough to take the case out of the rule and that, in consequence, the deficiency tax in issue is invalid to the extent that it is based on gains in sales of U. G. I. shares reckoned on the purchase price of the original 1,200 shares."

First. The Commissioner contends that Turner's communication to his broker of his intention to keep 1,200 shares of United Gas Improvement Co. stock was ineffective to identify the shares to be sold, because, from the very nature of these marginal operations, the shares were incapable of identification by the broker or anyone else. The basis for this contention are the facts that in such transactions no certificate is issued in the name of the customer, or earmarked for or otherwise allocated to him; that all certificates are in the name of the broker or street names; and that all certificates for stock of the same kind are commingled and held by the broker for the common benefit of all dealing in that particular stock. The fallacy of this argument lies in the assumption that shares of stock can be identified only through stock certificates. It is true that certificates provide the ordinary means of identification. But it is not true that they are the only possible means. Compare *Richardson* v. *Shaw*, 209 U. S. 365; *Gorman* v. *Littlefield*, 229 U. S. 19; *Duel* v. *Hallins*, 241 U. S. 523. Particularly is this so when, as here, the thing to be established is the allocation of lots sold to lots purchased at different dates and different prices.[2]

[2]The original regulation, Art. 4, ¶ 60, Regulation No. 33 (Revised), read, "When stock is sold from lots purchased at different times and at different prices, and the identity of the lots can not be determined as to the dates of purchase, the stock sold shall be charged against the earliest purchases of such stock." It has been suggested that, "Under the language quoted from

The required identification is satisfied, if the margin trader has, through his broker, designated the securities to be sold as those purchased on a particular date and at a particular price. It is only when such a designation was not made at the time of the sale, or is not shown, that the "First-in, first-out" rule is to be applied.[3]

Second. The validity of the regulation, thus construed, cannot seriously be questioned. The contention advanced by the taxpayers, both here and in the companion case of *Snyder* v. *Helvering*, that the regulation, as applied to marginal transactions, is invalid under the Fifth Amendment, because it creates a conclusive presumption, must rest wholly on the assumption that the shares traded on margin are incapable of identification. Since that assumption is erroneous, it is clear that no conclusive presumption is established. It is, at most, the burden of proof that is affected. For the margin trader, while being required to establish the identity of the shares in order to avoid the "First-in, first-out" rule, is left free to introduce any relevant evidence. Nor is he arbitrarily deprived of any of the important attributes of ownership, such as the "right to decide which stock he is going to sell." Indeed it is conceded, at least by the taxpayer in this case, that the regulation, as we now interpret it, "provides a useful and reasonable rule for ascertaining what stock was sold in cases where there is no proof, or lack of satisfactory proof, of the fact."

Third. If the facts found by the Board of Tax Appeals had been what the Court of Appeals assumed them to be, there would have been such an identification of shares sold with shares purchased as to preclude the Commissioner from applying the "First-in, first-out" rule. The Court of Appeals assumed that, "What Turner did in this case, acting and speaking through his attorney, was to communicate to his broker his intention to hold for investment the shares of U. G. I. he originally purchased." The facts found by the Board of Tax Appeals do not bear out this assumption of the court. The Board's findings were that, "The decedent

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Regulations 33, ["as to the dates of purchase", omitted in subsequent regulations] it might be argued that the identification intended could have been accomplished merely by recording 'the dates of purchase', rather than by requiring physical identification of the certificates." Wilkins, Identity of Marginal Transactions, Int. Rev. News, v. 4, no. 7, p. 5 (1931).

[3]Compare Howbert v. Penrose, 38 F. (2d) 577; Skinner v. Eaton, 45 F. (2d) 568; Snyder v. Comm'r of Internal Revenue, 54 F. (2d) 57; Comm'r of Internal Revenue v. Merchants' & Mfrs' Ins. Co., 72 F. (2d) 408.

[Turner] always intended to retain the ownership on margin of 1,200 shares of the United Gas Improvement Co. stock"; and that, "An employee of the broker understood . . . . that the decedent desired to retain 1,200 shares to take the place of the bonds which he had received from his father." The difference between the Board's findings and the court's statement of the facts is obviously vital. The court held that Turner's communication of his intention "was in effect an order to his broker not to sell those shares"; that "when, two years later, he ordered the broker to make two sales in lots of 500 shares each, they were, conformably to the original instructions, the 1,000 shares last purchased." But if the employee was told, as the Board found; merely that Turner "desired to retain 1,200 shares [of the U. G. I. stock] to take the place of the bonds which he had received from his father", he would naturally believe that so long as any 1,200 shares of the stock were retained, it was immaterial to which of the lots the sales in 1928 were attributed; and hence there was no identification. Thus it was only by departing from the facts as found by the Board of Tax Appeals that the court found justification for reversing the Board's decision.

Fourth. The Court of Appeals is without power, on review of proceedings of the Board of Tax Appeals, to make any findings of fact. "The Board of Tax Appeals is not a court. It is an executive or administrative board, upon the decisions of which the parties are given an opportunity to base a petition for review to the courts after the administrative inquiry of the Board has been had and decided." *Old Colony Trust Co.* v. *Commissioner of Internal Revenue*, 279 U. S. 716, 725. The function of the court is to decide whether the correct rule of law was applied to the facts found; and whether there was substantial evidence before the Board to support the findings made. See *Phillips* v. *Commissioner of Internal Revenue*, 283 U. S. 589, 599, 600; *Burnet* v. *Leininger*, 285 U. S. 136, 138; *Old Mission Portland Cement Co.* v. *Helvering*, 293 U. S. 289, 294.[4] Unless the finding of the Board involves a mixed question of law and fact, the court may not properly substitute its own judg-

[4]Compare Tracy *v.* Comm'r of Internal Revenue, 53 F. (2d) 575, 578-9; Slayton *v.* Comm'r of Internal Revenue, decided March 26, 1935, by the Circuit Court of Appeals for the First Circuit; Heywood Boot & Shoe Co. *v.* Comm'r of Internal Revenue, decided April 1, 1935, by the Circuit Court of Appeals for the First Circuit.

ment for that of the Board.[5] If the Board has failed to make an essential finding and the record on review is insufficient to provide the basis for a final determination, the proper procedure is to remand the case for further proceedings before the Board. Compare *Helvering v. Taylor,* 293 U. S. 507; *Murphy Oil Co. v. Burnet,* 287 U. S. 299, 308.[6] And the same procedure is appropriate even when the findings omitted by the Board might be supplied from examination of the record.[7]

Fifth. The Court of Appeals did not comment on the difference between the Board's findings and its own statement of the facts. Apparently it assumed that there was no difference, and reversed the Board's order, believing that it rested upon an erroneous ruling of law. For the court said that the Board made its determination "on the theory that the U. G. I. stock, which from time to time he [Turner] purchased on margin, and later sold, could be identified only by certificates; that as no certificates for shares were ever in his name, the shares sold could not be identified as shares purchased in any particular lot or at any particular time or price and, accordingly, charged the shares sold against those earliest purchased within the 'First in, first out' rule."

There is nothing in the opinion of the Board to indicate that its decision was based upon the "theory" stated by the court. There is nothing in the record to indicate that any such contention had been made by the Government before the Board; and Turner's petition for review by the Court of Appeals did not claim that the Board had acted upon that "theory".[8] But even if the Board's

[5]Compare Bishoff *v.* Comm'r of Internal Revenue, 27 F. (2d) 91, 92; Washburn *v.* Comm'r of Internal Revenue, 51 F. (2d) 949, 951; Tricou *v.* Helvering, 68 F. (2d) 280, 285.

[6]Compare Royal Packing Co. *v.* Comm'r of Internal Revenue, 22 F. (2d) 536, 538; Comm'r of Internal Revenue *v.* Langwell Real Estate Corp., 47 F. (2d) 841, 842; Independent I. & C. Storage Co. *v.* Comm'r of Internal Revenue, 50 F. (2d) 31, 33; Kansas City Southern Ry. Co. *v.* Comm'r of Internal Revenue, 52 F. (2d) 372, 379; Houston *v.* Comm'r of Internal Revenue, 53 F. (2d) 445; Underwood *v.* Comm'r of Internal Revenue, 56 F. (2d) 67, 73; Eau Clair Book & Stationery Co. *v.* Comm'r of Internal Revenue, 65 F. (2d) 125, 126.

[7]Compare Kendrick Coal & Dock Co. *v.* Comm'r of Int. Rev., 29 F. (2d) 559, 564; Francisco Sugar Co. *v.* Comm'r of Internal Revenue, 47 F. (2d) 555, 558; Beldridge Oil Co. *v.* Helvering, 69 F. (2d) 432.

[8]The Solicitor General stated in his petition to this Court for certiorari, that the question presented was "whether shares of stock held on margin are capable of identification so that a taxpayer selling part of his holdings may select, as his basis for determining gain or loss, the cost of any particular lot"; and counsel for the Government may have contended in the Court of Appeals, as he did here, that such identification is impossible. It is also true that the Board of Tax Appeals in other cases has approved the rule for which the Government is now contending. See Stryker *v.* Comm'r of Internal

decision had been based on an erroneous rule of law, that would not have justified its reversal, if the findings of fact, governed by the correct rule of law, were sufficient to sustain the decision and had substantial support in the evidence.[9]

Sixth. The Court of Appeals did not explicitly hold that the Board's finding as to Turner's communication to his broker was without substantial support in the evidence. The court, in its opinion, does state that, "The evidence shows conclusively that Turner was sentimental about keeping the original 1,200 shares as an inheritance from his father; that his 'intention' was to retain as an investment the shares originally purchased and sell in speculation the shares more recently acquired". It does not state that the evidence was equally conclusive as to the communication to the broker of this exact intention. There was, it is true, testimony to the effect that "from the very beginning West & Company knew Mr. Turner's intentions and knew he was keeping the first purchase of 1,200 shares"; and the failure of the Board so to find, was assigned as error by the taxpayer in his petition for review. But there was also testimony showing that Turner, during 1928, traded heavily in 20 other issues of stock. The Court of Appeals did not consider whether, in view of this and other evidence, the Board might reasonably have concluded that the testimony as to the broker's knowledge of Turner's intention was not entirely accurate, and that the broker's only clear understanding of Turner's intention was that, throughout his extensive trading, 1,200 shares of United Gas Improvement Co. stock were to remain in his account. Since this question was not considered in the court below nor argued here, the case must be remanded to the Court of Appeals for further consideration.

Reversed.

Mr. Justice STONE thinks that the judgment of the Court of Appeals should be reversed and the order of the Board of Tax Appeals affirmed, on the grounds that the petitioner failed to show that the particular shares sold were capable of identification with respect to the date of their purchase, and that they could not be identified merely by designating them to the broker as the shares to be sold.

Revenue, 21 B. T. A. 561; Leng *v.* Comm'r of Internal Revenue, 22 B. T. A. 149; Seelye *v.* Comm'r of Internal Revenue, 29 B. T. A. 695; compare Kelchner *v.* Comm'r of Internal Revenue, 31 B. T. A. 262.

[9]Compare Lewis-Hall Iron Works *v.* Blair, 23 F. (2d) 972, 974-5; Hurwitz *v.* Comm'r of Internal Revenue, 45 F. (2d) 780, 781; Dickey *v.* Burnet, 56 F. (2d) 917, 918.